ALTERNATIVES 101

What are alternative investments?

Alternative investments or "alternatives" generally consist of any investment that falls outside traditional stock, bond and cash categories. Alternatives include asset classes such as private equity, hedge funds, private credit, and private real estate.

Who can invest in alternative investments?

Under most circumstances, investors in alternatives must satisfy "accredited investor" or "qualified purchaser" credentials. An accredited investor is an individual or business that has passed certain criteria to trade in specific securities that are not registered with financial authorities. Qualified purchasers must have $5 million in investible assets. Typical investors include institutional investors such as pension funds, foundations, family offices, and wealthy individuals.

PRIVATE EQUITY

WHAT IS A PRIVATE EQUITY FUND?

Private equity consists of investments in private, non-publicly held companies. Private equity firms specialize in selecting companies for private equity funds, many of which specialize in investing in specific industries. These funds seek to provide net returns that exceed public equity markets and they have historically achieved this objective in aggregate. In many instances, fund managers are providing capital and strategic guidance to their portfolio companies to seek to enhance value.

TYPICAL FEE STRUCTURE

Private equity funds have a **management fee that typically ranges from 1% to 2.5%.** There is also an additional fee known as **carried interest (also known as carry) that is generally around 20%.** The private equity manager will earn this additional compensation if the fund achieves a previously agreed upon minimum return over a hurdle known as the preferred return. This hurdle is commonly around 8%. This additional carried interest aligns the fund manager's (the General Partner's) compensation with the fund's return for its investors (the Limited Partners).

WHY PRIVATE EQUITY OVER PUBLIC EQUITY?

Private equity allows for investment in companies that are not listed or traded on a stock exchange. These companies generally have a higher risk/reward profile and may provide diversified returns to traditional asset classes.

FUND LAUNCH PROCESS

During a private equity fund's capital raising process, the fund is marketed to potential investors. This process can be lengthy and last several months to multiple years. After investor commitments are made and the fund launches, the fund manager will typically issue a capital call to request each investor's pro rata share of their capital commitment to be deployed in companies the fund manager deems worthy of an investment.

ARE ASSETS LOCKED UP IN A PRIVATE EQUITY FUND?

The typical term for a private equity fund is 10 years and may come with extension options at the discretion of the fund manager. A private equity fund manager commonly deploys capital during the first three to five years and harvests those returns during the latter half of the fund's life.

A PRIVATE EQUITY MANAGER'S "VALUE ADD"

After extensive due diligence, the private equity fund invests in companies that the manager believes have the potential to show significant growth. Once the investment is made, the fund manager works closely with management teams of the selected companies to help with operational improvements and potentially create better economies of scale.

Pros
Potential for Higher Returns than Public Equities
Manager Typically Invests Alongside
Access to Exclusive Deals
Historically Low Correlation to Fixed Income
Private Equity Manager Engagement with Company

Cons
Higher Risk than Public Equities
High Fees
Illiquid
Less Transparent than Public Equities
High Investment Minimums

Diversification does not guarantee a profit or protect against loss.

HEDGE FUND

WHAT IS A HEDGE FUND?

Hedge funds are actively managed funds that pursue more specialized investment strategies and can generally be bought by accredited investors. Many hedge funds seek to deliver positive absolute returns in all market environments and many employ leverage and short selling strategies. Unlike mutual funds, hedge funds are not registered as an investment company and usually interests in a hedge fund are not registered under the Securities Act of 1933. In addition, a hedge fund manager may not be required to register as an investment adviser.

TYPICAL FEE STRUCTURE

"2 & 20" is a common fee structure for a hedge fund, meaning a 2% management fee and 20% profit sharing. Profit sharing is also known as performance fee/incentive fee/carried interest (also known as carry), and is a share of the fund manager's profits. In addition to **"2 & 20"**, there is an additional fee paid to the fund manager when they deliver strong returns over a target known as the "hurdle rate" or "high watermark."

WHAT DO HEDGE FUNDS INVEST IN?

Hedge funds have broad investment mandates and can invest in combinations of stocks, bonds, real estate, derivatives, currencies, among other asset classes. Hedge funds utilize complex strategies such as long/short equities, equity market neutral, arbitrage, multi-strategy, global macro, among others. Hedge funds are governed by an offering memorandum, also referred to as Private Placement Memorandum that includes a description of the fund's investment strategy, risks, fees, expenses, and conflicts of interest.

WHY INVEST IN HEDGE FUNDS?

Hedge fund investors generally seek uncorrelated returns, potential for positive returns in all market environments, downside mitigation, diversification, and/or strong risk-adjusted returns.

ARE ASSETS LOCKED UP IN A HEDGE FUND?

It is common for assets in a hedge fund to be locked up for one year or more, with some allowing for quarterly liquidity if investors want to redeem shares. Lock-up provisions depend on the liquidity profile on the underlying investment (i.e. less liquid assets tend to have longer lock-ups).

DO HEDGE FUNDS USE LEVERAGE?

Yes, most hedge funds utilize varying forms of borrowing to enhance returns. It is common to see funds range from 1x to 5x leverage, and even some surpassing that range. Higher leverage often increases the risk/reward profile of a fund.

Pros
"All Weather" Investments
Potentially, access to Top Tier Managers
Wide Investment Mandates
Historically Low Correlation to Stocks and Bonds
Potential for Higher Returns than Public Funds

Cons
Higher Risk than Public Funds
High Fees
Illiquid
Less Transparent than Public Funds
High Investment Minimums

PRIVATE CREDIT

WHAT IS A PRIVATE CREDIT FUND?

Private credit funds are portfolios of private loans made to borrowers in need of capital. These borrowers can be businesses or individuals who may require non-bank financing due to their higher risk profile. A private credit fund manager seeks to provide above-average yields as compared to traditional fixed income.

TYPICAL FEE STRUCTURE

Private credit funds have a **management fee that typically ranges from 1% to 2.5%**. There is also an additional fee known as **carried interest (also known as carry) that is generally around 20%**. A private credit manager will earn this additional compensation if the fund achieves a previously agreed upon minimum return over a hurdle rate known as the preferred return. This hurdle is commonly around 8%. This additional carried interest aligns the fund manager's (the General Partner's) compensation with the fund's returns for its investors (the Limited Partner's).

TYPES OF PRIVATE CREDIT

Common types of private credit are senior loans, mezzanine debt, direct lending, special situations, and distressed debt. There are also specialty funds that pursue niche strategies such as purchasing nonperforming loans, purchase life settlements, and even music royalties.

WHY PRIVATE CREDIT OVER TRADITIONAL FIXED INCOME?

Private credit has a number of potential benefits such as current income, potentially higher returns versus traditional fixed income, low correlation to other asset classes, and generally lower volatility. However, investing in private credit includes heightened risk such as liquidity and credit risk.

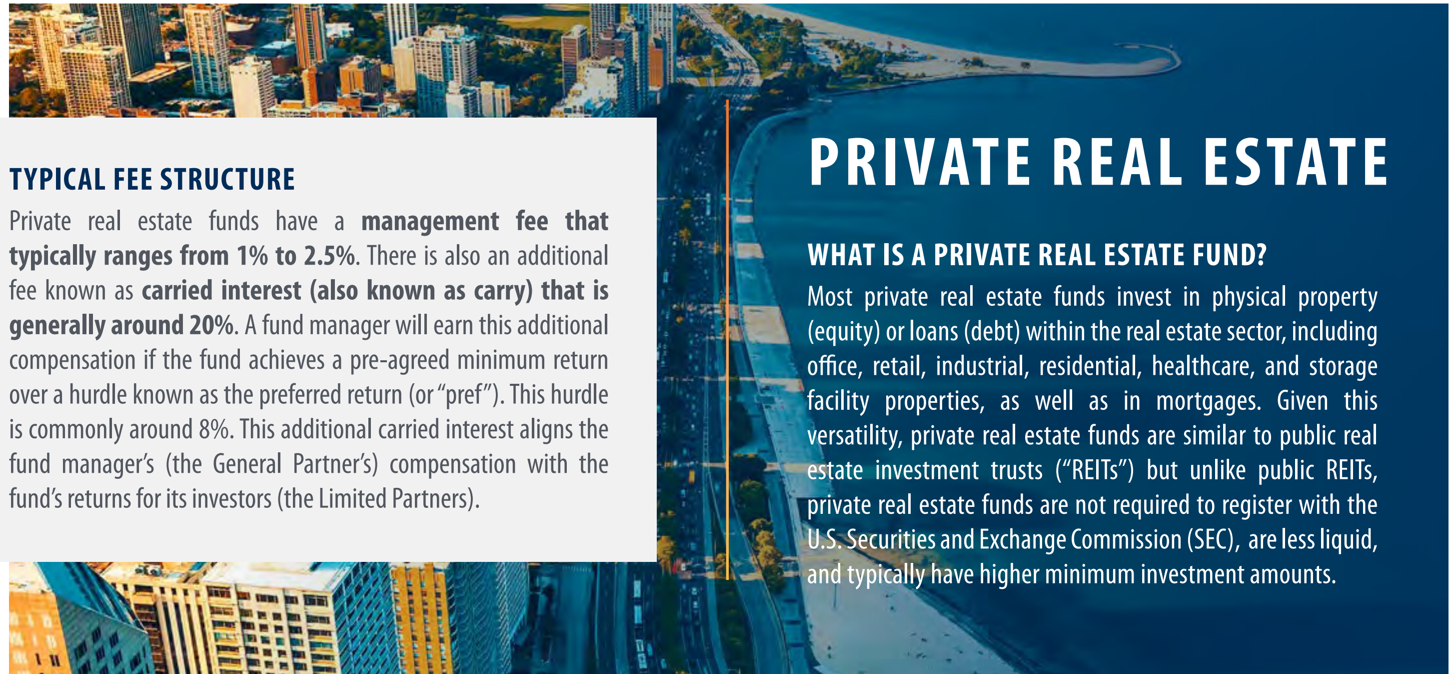
ARE ASSETS LOCKED UP IN A PRIVATE CREDIT FUND?

The standard term for a private credit fund is 5 to 10 years and can come with extension options at the discretion of the fund manager. The investment process depends on the type of fund offered, but some funds may be more active and others more passive.

A PRIVATE CREDIT MANAGER'S "VALUE ADD"

A private credit fund's manager relies heavily on their network in loan origination. In addition, many private credit fund managers have typically developed a specialized area of expertise that can be leveraged in delivering alpha to the fund's investors. There can be a wide dispersion in returns between funds, so manager selection is a key element for the potential to generate strong returns.

Pros	Cons
Potential for Higher Yields	Higher Risk than Public Funds
Manager Typically Invests Alongside	High Fees
Total Return Potential	Illiquid
Low Correlation to Traditional Assets	Less Transparent than Public Funds
Generally, more stable Current Income	High Investment Minimums



PRIVATE REAL ESTATE

WHAT IS A PRIVATE REAL ESTATE FUND?

Most private real estate funds invest in physical property (equity) or loans (debt) within the real estate sector, including office, retail, industrial, residential, healthcare, and storage facility properties, as well as in mortgages. Given this versatility, private real estate funds are similar to public real estate investment trusts ("REITs") but unlike public REITs, private real estate funds are not required to register with the U.S. Securities and Exchange Commission (SEC), are less liquid, and typically have higher minimum investment amounts.

TYPICAL FEE STRUCTURE

Private real estate funds have a **management fee that typically ranges from 1% to 2.5%**. There is also an additional fee known as **carried interest (also known as carry) that is generally around 20%**. A fund manager will earn this additional compensation if the fund achieves a pre-agreed minimum return over a hurdle known as the preferred return (or "pref"). This hurdle is commonly around 8%. This additional carried interest aligns the fund manager's (the General Partner's) compensation with the fund's returns for its investors (the Limited Partners).

TYPES OF PRIVATE REAL ESTATE

Common types of private real estate include office properties, residential (single and multi-family), industrial, retail, hotels, land, and real estate debt. In addition to private real estate funds that invest in buildings, there are funds that focus on areas such as debt, value-add, and development. Each private real estate fund has its own terms and risk/reward profile.

WHY PRIVATE REAL ESTATE OVER PUBLIC REITs?

Private real estate has a number of potential benefits such as stable current income, higher returns, low correlation to other asset classes, tax benefits, and historically lower volatility. With these potential benefits also comes risks including but not limited to interest rates, geographical location of properties, liquidity, and leverage.

ARE ASSETS LOCKED UP IN A PRIVATE REAL ESTATE FUND?

Some private real estate funds are "evergreen" meaning they do not have a termination date and are perpetual in nature. Other funds have a term that may range from 3 to 10 years. The investment process depends on the type of fund offered, but some funds can be more active and others more passive.

POTENTIAL TAX BENEFITS OF PRIVATE REAL ESTATE

Real estate investing is popular in part because of its potential tax advantages in the United States. Unlike investing in a corporation where investors are subject to double taxation (i.e. the corporation pays tax on its taxable earnings and the investor pays tax when the corporation pays a dividend), earnings are only taxed once in a REIT since the REIT is considered a "pass-through entity". In a public REIT, there is a requirement to distribute 90% of earnings to investors, allowing the REIT to avoid paying corporate income tax on distributed profits. Further, in a private real estate fund, assets can be depreciated, and that benefit can be passed along to individual investors. There are also more complex techniques such as 1031 Exchanges that allow investors to defer capital gains upon sale.

Pros	Cons
Potential for Higher Income than Public Real Estate Funds	Higher Risk
Potential Tax Benefits	High Fees
Potential Inflation Hedge	Illiquid
Historically Low Correlation to Stocks and Bonds	Less Transparent than Public Real Estate Funds
Low Volatility Potential	High Investment Minimums

CO-INVESTMENT

WHAT IS A CO-INVESTMENT?

Co-investments are mainly minority investments in a company made by investors alongside private equity fund managers. A private equity fund manager identifies an investment opportunity to offer prequalified investors an additional direct investment in a private company. This process is generally done outside the private equity fund via a Special Purpose Vehicle.

TYPICAL FEE STRUCTURE

Co-investments historically have lower fees than a private equity fund. Fees are generally reduced, or management fees may be eliminated altogether in an individual co-investment opportunity.

HOW TO ANALYZE CO-INVESTMENTS

Co-investments are individual deals that originate from a private fund manager and must be analyzed on a case-by-case basis by the end investor. Often, co-investments are offered from private equity fund managers but can also be offered from other managers within private credit, private real estate, and hedge funds. For simplicity, we will discuss private equity co-investments. This can require expertise and a rapid deployment of capital into the target company. Investors must look at where the co-investment would fit inside of a well-diversified portfolio. Many investors rely on guidance from the private equity fund manager but must make their own investment decisions.

EXAMPLE OF A CO-INVESTMENT

Co-investments arise when a private equity fund wishes to make an investment in a company that has additional funding requirements. Due to constraints on the private equity fund manager, they are unable to fund the additional requirement on their own so they approach pre-qualified individual investors regarding investing alongside the private equity fund.

BENEFITS OF CO-INVESTMENTS

Co-investments generally provide investors with lower fees than investing directly in the private equity fund they are co-investing with. In addition, many investors aim for higher net returns through these higher risk/higher reward investments. Higher returns are not always guaranteed given the highly concentrated nature of investing in individual co-investment deals.

Pros
Potential for Heightened Returns
Generally Reduced Fee Structure
J-Curve Mitigation
Closer Relationships with Investment Manager

Cons
Idiosyncratic Risk to Specific Deals
Limited Time to Make Decision
Illiquid
Due Diligence Expertise Required

GLOSSARY OF KEY TERMS RELEVANT TO ALTERNATIVE INVESTMENTS

General Alternative Investments

Accredited Investor: An individual or business that is allowed to trade in securities such as hedge funds that may not be registered with financial authorities. Certain tests must be met such as having an average yearly income over $200,000 (or $300,000 for joint income) or having a net worth exceeding $1 million. Certain persons deemed to have an adequate level of financial expertise may also qualify. For full definition, refer to SEC Rule 501 of Regulation D.

Carried Interest: A share in the profits earned by general partners of private funds and is due to the general partners based on their role rather than an initial investment in the fund.

Committed Capital: An obligation, typically the maximum amount that a limited partner agrees to invest in a fund.

Deal flow: A measure of the number of potential investments that a fund reviews in any given period.

Drawdown: Money that is committed by limited partners and made available when the need arises for an investment in a fund.

General Partner (GP): A class of partner in a partnership. The general partner retains liability for the actions of the partnership. In the private equity world, the GP is the fund manager while the limited partners (LPs) are the institutional and high net worth investors in the partnership. The GP earns a management fee and a percentage of profits (see carried interest).

Illiquidity Premium: Higher return potential for the additional risk of locking up capital in less liquid alternative assets.

Internal Rate of Return (IRR): The interest rate at which a certain amount of capital today would have to be invested to grow to a specific value at a specific time in the future. Takes into account the amount and timing of cash flows.

J-Curve: A common chart used to show immediate losses in private funds such as private equity, private credit, and private real estate as a result of fees, reflecting the shape of the letter J – down in the beginning, then up towards the end. It can take a private equity fund several years to deploy capital and begin to create capital appreciation and realize gains on its investments.

Key Man Provision: An investment manager is owned or controlled by one or more key persons and a fund's future success is perceived to be particularly dependent upon those key persons. An investor may seek to protect themselves against 'key man risk'. A typical 'key man' provision will provide that if the 'key man' ceases to be actively involved in the management of the particular fund for more than a specified number of days, the fund will notify the investor who may then quickly redeem their investment.

Limited Partnership: A legal entity composed of a general partner and various limited partners. The general partner manages the investments and is liable for the actions of the partnership while the limited partners are generally protected from legal actions and any losses beyond their original investment. The general partner receives a management fee and a percentage of profits (see carried interest), while the limited partners receive income, capital gains and tax benefits.

Limited Partner (LP): An investor in a limited partnership. The general partner is liable for the actions of the partnership while the limited partners are generally protected from legal actions and any losses beyond their original investment. The limited partner receives income, capital gains and tax benefits.

Multiple on Invested Capital (MOIC): A quick indicator of the gross return on investment. If a $100,000 investment appreciates to a total value of $500,000, the MOIC is 5x. MOIC does not account for any specific time horizon.

Offering memorandum (or Private Placement Memorandum): Contains important information about investing in a fund, including the fund's investment strategy, risks, fees, expenses and potential conflicts of interest of the fund's manager.

Preferred Return ("Pref"): Minimum annual return that the investors (LPs) are entitled to before the managers (GPs) may begin receiving carried interest. This figure is typically around 8%.

Qualified Purchaser (QP): A QP is a person or business that holds an investment portfolio with a value of $5 million or more. This is a step above the Accredited Investor status, and many hedge funds may require its investors to be qualified purchasers, demonstrating they have significant wealth. For full definition, refer to Section 2(a)(51) of the Investment Company Act of 1940.

Qualified Institutional Buyer (QIB): A Qualified Institutional Buyer (QIB) is an institutional purchaser that must meet specific requirements for eligibility in certain alternative investments. For full definition, refer to Rule 144A of the Securities Act of 1933.

Side Letters: Documents between private fund GPs and select investors granting special rights and privileges to whom are deemed significant or key investors. These are generally offered to large investors, or at times, early investors in a fund.

Vintage: The year that a private equity fund stops accepting new investors and begins to make investments on behalf of those investors.

Waterfall (European): In a fee structure more favorable to investors, sponsors do not receive carried interest until all of the LP's capital contributions have been recovered and their preferred rate of return has been reached.

Waterfall (American): In a fee structure more favorable to PE managers, sponsors receive carried interest from individual investments in the fund before the investors are made whole.

Private Equity

Buyout: A segment of the private equity industry. Also, the purchase of a controlling interest of a company by an outside investor (in a leveraged buyout) or a management team (in a management buyout).

Distributed to Paid-in Capital (DPI): A measure of the cumulative investment returned to the investor relative to invested capital. This is expressed in a multiple of 1.2x, 2.0x, etc.

Exit Strategy: A fund's intended method for liquidating its holdings while achieving the maximum return possible. Typically, the options are to merge, be acquired or pursue an initial public offering.

Initial Public Offering (IPO): The initial offering of shares in a private company to the public. New public offerings must be registered with the Securities and Exchange Commission.

Leveraged Buyout (LBO): The purchase of a company or a business unit of a company by an outside investor using mostly borrowed capital.

Management Buyout (MBO): A leveraged buyout controlled by the members of the management team of a company or a division.

Paid-in Capital (PIC): The total amount of committed capital called by a fund at any given time.

Residual Value to Paid-in Capital (RVPI): A measure of how much of the investors' capital is still invested, or unrealized in the equity of the fund.

Total Value to Paid-in Capital (TVPI): The ratio of the current value of remaining investments within a fund, plus the total value of all distributions to date, relative to the total amount of capital paid into the fund to date. Thus, TVPI = DPI + RVPI.

Venture Capital: A segment of the private equity industry which focuses on investing in startups or early-stage companies with expected high growth rates.

Hedge Funds

Domicile: In the simplest sense, a fund's domicile refers to its home or where it is structured for legal and tax purposes. Most hedge funds offered to US-based taxable investors are organized as a Delaware entity because of the state's well developed and business-friendly laws. If a US hedge fund manager intends to attract non-US investors, they may also have offshore "feeder" funds. Most offshore funds are domiciled in the Cayman Islands due to the country's tax-neutrality.

Gates: A "gate" provision is a hedge fund manager's right to limit the amount of withdrawals on any withdrawal date to no more than a stated percentage of a fund's net assets — often 10% to 25%, depending on how frequently investors have a right to withdraw capital.

Gross Exposure: The value of a fund's long positions plus its short positions. If a fund is 70% long and 30% short, the gross exposure is 100%. If gross exposure is greater than 100%, then a form of leverage is being used to enhance returns. It is common to see gross exposure of a hedge fund range from 100% to several hundred percentage points.

Hard Close: When a hedge fund does not allow any new money into the fund from either new or existing investors.

Hedge: A hedge can be thought of as an insurance-like investment that may protect investors from some losses. Hedging a portfolio is not a free lunch, as there are costs associated with doing so. Hedging is typically done by taking an offsetting position in a related security such as taking short positions or utilizing other financial instruments such as forward contracts, or futures options.

High-Water Mark: The minimum level that a hedge fund manager needs to achieve to receive carried interest/performance fees. This is typically the highest value a fund has reached since its inception, and helps align interest for the manager to continue to achieve growth. For example, if a $1,000,000 investment is made and the fund declines by 20% in year one, $800,000 remains in the fund. If in year two, the fund returns 25%, bringing the investment value back to $1,000,000, carried interest is not collected since there were no gains over the $1,000,000 high-water mark. If in year two, the fund actually returned 40% from its $800,000, then the value is now $1,120,000 and carried interest can be collected on the $120,000 gain.

Leverage: Used in many hedge funds to enhance returns. Many fund managers will use lines of credit for the potential to outpace the interest charged in the borrowing. While leverage can magnify returns, it can also magnify losses if a fund manager's investment thesis does not pan out as intended.

Long/Short: "Long" and "short" are investment terms used to describe ownership of securities. To buy securities is to "go long." The opposite of going long is "selling short." Short selling is an advanced trading strategy that involves selling a borrowed security. Short sellers make a profit if the price of the security goes down and they are able to buy the security at a lower amount than the price at which they sold the security short.

Master-Feeder Structure: A master-feeder structure is a device commonly used by hedge funds to pool taxable and tax-exempt capital raised from investors in the United States and overseas into a master fund. Separate investment vehicles, otherwise known as feeders, are established for each group of investors. The feeders may differ in investment type, fee structures, investment minimums, and various other operational attributes.

Net Exposure: In a long/short fund, this is the value of the long positions minus the value of the short positions. If a fund is 70% long and 30% short, the net exposure is 40% (70% minus 30%). This indicates that there is net long exposure, or a bias towards the long portion of the book.

Soft Close: When a hedge fund does not allow any new money into the fund from new investors. A soft-closed fund generally only allows investment from existing investors prior to the close.

Private Credit

Asset-Backed Securities (ABS): ABS are created by buying and bundling loans such as residential mortgage loans, commercial loans or student loans to create securities backed by those assets, which are then sold to investors.

Collateralized Loan Obligation (CLO): An actively managed securitized product created to acquire and manage a pool of leveraged loans.

Direct Lending: The largest segment of the private credit market, in which loans are typically issued directly to small and medium enterprises (SMEs).

Distressed Debt: A strategy of buying the debt of companies that are in bankruptcy or are likely to enter bankruptcy. The debt may be bought at a significant discount, with the goal being the value of the company improves over time.

Leveraged Loan: Leveraged loans are a type of syndicated loan for below investment grade companies. These loans generally pay higher interest rates to lenders because of the higher level of risk.

Mezzanine: Mezzanine financing is a hybrid of debt and equity financing that gives the lender the right to convert the debt to an equity interest in the company in case of default. Mezzanine debt is typically used to finance leveraged buyouts, recapitalizations and corporate acquisitions.

Securitization: The pooling of assets in order to repackage them into interest-bearing securities. This is done to transform non-tradable assets into tradable securities.

Private Real Estate

1031 Exchange: A 1031 exchange is a real estate investing tool that allows investors to swap out an investment property for another investment property and defer capital gains thus deferring the tax that would be due if the property were sold outright.

Appraisal: An estimate of a property's current fair market value.

Broker Opinion of Value (BOV): A Broker Opinion of Value is an estimate of a property's value that is completed by a commercial real estate broker. This is commonly completed when an owner wants to sell a property.

CapEx: Capital expenditures used by real estate companies to invest, purchase, renovate, and maintain physical assets.

Capitalization Rate (Cap Rate): A measure used to estimate and compare the rates of return on multiple properties. Cap rates are calculated by dividing the net operating income (NOI) by its property value. Cap rates can vary based on asset class, geographical location or tenants.

Depreciation: The accounting convention which allocates the costs of purchasing and improving a property to future periods. The recording of depreciation results in tax deductions.

Gross Asset Value (GAV): GAV is used to describe the current market value of all assets held within a property fund.

Net Asset Value (NAV): The total value of all property assets minus any outstanding debt and the cost of other capital expenses.

Net Operating Income (NOI): A formula used in real estate to calculate income after operating expenses are deducted, but before deducting interest and taxes. It is useful for estimating the revenue potential of an investment property.

Qualified Opportunity Zone (QOZ): A US program created in 2017 as part of the Tax Cuts and Jobs Act which provides enhanced tax treatment for investments made into designated economically distressed communities.

Triple Net Lease (NNN): A triple net lease places responsibility on a tenant for three payments in addition to rent: building maintenance, insurance, and property taxes.

Alternative investments may employ complex strategies, have unique investment and risk characteristics that may not be suitable for all investors. An investor should read the applicable offering documents before investing in any private fund.

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